NAFTA's Chapter 11 and the Environment

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1. Introduction

This paper seeks to communicate in a brief format the concerns that the International Institute for Sustainable Development has raised in its extensive analysis and consultation on the environmental implications of NAFTA's Chapter 11. Much of the paper is based on previous work done by IISD.[1] The paper has also been informed by a series of tri-national experts' workshops on the environmental implications of Chapter 11, held in the spring of 2002 in the NAFTA capitals, convened by IISD and partner institutions.[2]

The starting assumptions in the workshops, and in the present analysis, are twofold: first, investment can be a major contributor to sustainable development. Indeed, it is difficult to imagine a transition to sustainable development without substantial foreign direct investment, particularly in those countries where rates of savings are low. Second, environmental protection is also fundamental to achieving sustainable development, and one of the keystones of such protection globally is strong and effective systems of environmental management at the national levels. The challenge we face is to reconcile these two goals: to foster foreign direct investment in ways that do not undermine the ability of national governments to ensure that investment, and other economic activity, contributes to sustainable development.

2. The Context: Why conclude investment agreements?

NAFTA's Chapter 11 investor protection is a product of history. Efforts to protect offshore investments date as far back as the Friendship, Navigation and Commerce treaties that first appeared in the late 1700s. International law on investment evolved over time in response to changing patterns of commerce, and changing political realities, and in the late 1970s the US began to pursue the agreements known as Bilateral Investment Treaties (BITs). The investment protection provisions of the modern BITs are essentially the same as those found in Chapter 11.

Vandeveld (1992:22) describes the US motivation for concluding BITs:

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[1] See IISD (2001), Mann and von Moltke, (1999) and Mann and von Moltke (2002).

[2] "Protecting Investor Rights and the Public Good: Assessing NAFTA's Chapter 11," Mexico City, March 13; Ottawa, March 18; Washington, April 11. For a description of the workshops and access to the agendas, participants' lists and background papers, see http://www.iisd.org/trade/ILSDWorkshop.

> "The BITS … were born of economic, legal and political considerations. The economic consideration was to protect existing American investment against a variety of threats, including discriminatory treatment, exchange controls, and expropriation. The legal consideration was to strengthen customary international legal protection for investment. The political considerations were to reduce pressure from Congress and the American business community for action to protect foreign investment and to demonstrate to foreign governments that the United States was committed to protecting its overseas investment."

By the time of the negotiation of the NAFTA that commitment was assumed, and there was not as great a need for strengthened customary international law on investment, leaving the desire to protect American investment abroad. By this time another objective had begun to appear as well: the liberalization of international investment. Beyond simply protecting investments from mistreatment by foreign governments, this new objective sought the elimination of barriers to investment, in the form of performance requirements or restrictions on rights of establishment. Chapter 11 encompasses both objectives.

It is interesting to note that Vandeveld continues: "None of the considerations supporting negotiation of the BITs included the actual promotion of investment in developing countries." This increase in investment was precisely Mexico's interest in signing the agreement. Mexico saw its commitment to liberalization, and perhaps more important, its willingness to *lock in* those commitments, as an important sign for investors that the country was through with its old nationalist policies, and was now a desirable destination for investment. Canada, for its part, recognized the value of an agreement that might increase investment opportunities in Mexico, but at the same time sought to limit the scope of the agreement to impact on Canada's own investment regulatory structure.

Investment, however, is not an end in itself. The point of protecting, promoting and attracting foreign investment is to realize the economic growth that it can bring to both investor and host countries. This paper will argue that the pure economic driver of investor protection under NAFTA, while perfectly appropriate when viewed from a traditional purely commercial perspective, has led to serious unintended problems for non-commercial areas of public interest.[3]

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[3] While the argument is made here in the context of NAFTA, it applies with equal force to the BITs.

3: What are the concerns with Chapter 11?

The concerns with Chapter 11 fall mainly into three categories: the provisions, the scope of coverage and the process.

3.1. The Provisions

Chapter 11 incorporates the standard protections found in the BITs model, but those provisions with the greatest potential to conflict with non-commercial policy objectives are:

- Protection from expropriation, or measures tantamount to expropriation (Article 1110)
- National treatment obligations (Article 1102)
- Prohibition of performance requirements (Article 1106)
- Obligations for minimum international standards of treatment (Article 1105)

2.1.1. Protection from Expropriation

Article 1110 stipulates that any expropriation must be:

a) For a public purpose
b) Non-discriminatory (that is, not targeted at a specific company or nationality)
c) In accordance with the due process of law; and
d) Compensated by the expropriating government.

None of this is surprising or unreasonable, but the key question is: where do we draw the line between the legitimate exercise of government regulatory authority – which often causes economic pain to selected firms or sectors – and compensable expropriation? Such a line has traditionally existed in international law in the "police powers" doctrine: non-discriminatory measures aimed at protecting public welfare (e.g., public health, the environment, *ordre public*), are not considered expropriation, even if they cause economic damage to some firms. As this "carve-out" is not made explicit in the text of Article 1110, it is not clear whether it exists. If it does not, then any tough environmental regulation

will involve paying damages to the affected businesses.[4] This constitutes in effect a "pay the polluter" scheme, whose potential for chilling new regulations should be obvious.

The most troubling ruling on this subject to date has come from the *Metalclad* panel, which ruled that the objective of the contested measure was not important in determining whether it was an expropriation – that the only important consideration was the extent of the damage. The *Pope & Talbot* case had elements of the same reasoning. Following these rulings would seem to extinguish the police powers exemption, and subject *all* government regulations to attack as compensable expropriation, provided it can be shown that a substantial enough damage has been inflicted. The *Methanex* case will offer another chance to rule on the same issue.

3.1.2. National Treatment

Article 1102 obliges Parties to "accord to investments of investors of another Party treatment that is no less favourable than that it accords, in like circumstances, to those of its own investors." The main cause for concern here is the difficulty in determining whether circumstances are "like." Clearly the text does not mean "identical," but neither does it give any guidance on how to determine whether circumstances are sufficiently similar as to trigger this obligation.

Fore example, if several existing firms are already polluting to the maximum allowed in a certain ecosystem, would a refusal to permit a foreign investor to open another plant at the same site amount to a breach of national treatment? Certainly the foreign investor is not being treated as well as the existing domestic firms. Or if, as in the *Pope & Talbot* case, if a Federal regulation is designed such that its effects are felt more heavily in an investor's host province than in other provinces, does this breach the national treatment obligations?

3.1.3. Performance requirements

Article 1106 prohibits host countries imposing certain types of requirements on investors as a condition of entry and establishment. Among the requirements proscribed are demands to export a certain percentage of sales, demands to

[4] While all regulations would be subject to scrutiny, it is unlikely that all damages would be compensable. According to the developing case law, there would have to be a *substantial diminution* of the expected value of the investment before compensation would be due.

purchase locally for certain inputs and demands to transfer certain technologies to the host country.

The concern here is that in several cases now it has been argued (though no ruling has been issued) that an import ban constitutes a performance requirement. In *Crompton*, for example, Canada banned the import of lindane-based seed treatments for canola on environment and health grounds. But Crompton US, the manufacturer, claims that the ban forces its Canadian subsidiary to buy local substitutes, and thus is in effect a local purchasing requirement. Ethyl made similar arguments in its case, which Canada settled out of court. Import bans being a frequently used tool of environmental policy for dealing with toxic substances, this development is worrying.

3.1.4. Minimum Standard of Treatment

Article 1105 requires that investors shall receive treatment "in accordance with international law, including fair and equitable treatment …" The text leaves this requirement undefined, and before it was specifically ruled out by a Free Trade Commission interpretive note dated July 2001, several cases interpreted it to mean that investors were due treatment spelled out in *any* international law, including the WTO, and even non-Chapter 11 parts of NAFTA. The concern now is that the interpretive note may not have the intended effect when read by arbitral panels under Chapter 11.[5]

Further, in retrospect the note would not have prevented certain troubling rulings issued before its release. In *Metalclad*, for example, the tribunal ruled *inter alia* that the government of Mexico was liable for the assertions of a single bureaucrat, and that the government had a duty to correct legal misunderstandings held by the investor. These are extremely broad readings of 1105, and if followed would impose dauntingly high hurdles on national regulatory and administrative processes.

3.1.5. Conclusions

In the case of all these provisions, the concerns are about interpretations that go far beyond what the drafters of the text intended. As Mann (2001) argues, the provisions have gone from being tools of last-resort protection from unfair treatment to weapons of choice for preventing or attacking unfavourable regulations – they have gone from shield to sword. To some extent the narrow

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[5] See International Institute for Sustainable Development (2002).

commercial focus of the negotiators prevented them from foreseeing, or worrying about, the kinds of impacts the provisions threaten to have on other spheres of public policy.

There was some recognition of this fact in the Free Trade Commission's (FTC's) July 2001notes of interpretation dealing with transparency and minimum international standards of treatment.[6] The Statement interpreted the scope of the Article 1105 to be limited to customary international law, meaning it could no longer be used as a conduit for introducing obligations from trade law and other sources.[7]

The interpretive statement was issued under the authority granted the FTC by NAFTA Article 1131 (b), which states that, "An interpretation by the Commission of a provision of this Agreement shall be binding on a Tribunal established under [Article 11 Section B]." Such a vehicle might also be used to address the other problems noted above, provided there were consensus among the Parties on the appropriate solutions.

3.2. The Scope of Coverage

Chapter 11 has alarmingly broad definitions of both "investment," and of "measures" that can trigger the Chapter's application. An investment is anything from an enterprise to a debt security or loan to an enterprise. A holder of a bond in a multinational enterprise is thus an investor, conferred with the extensive rights discussed above, and availed of the powerful process described below.

This definition has been extended by several rulings that have agreed to define a company's *market share* as an investment asset that can be protected. So when Pope & Talbot's US market share decreased as a result of Canadian government policy, it was entitled to compensation.[8] In effect this approach has the potential to bring the full gamut of *trade* measures under the purview of NAFTA's *investment* law, as most trade measures will affect market share. This would greatly extend the reach of the provisions, and would grant more access to the direct investor-state process (discussed below) than was ever intended.

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[6] Free Trade Commission, 2001.

[7] For an analysis of the Statement, see International Institute or Sustainable Development, 2001.

[8] Or, more accurately, the panel ruled that P&T *would* have been entitled to compensation had they been able to show a significant loss, but they could not.

A "measure," according to NAFTA's Chapter 2 – it is not defined in Chapter 11 – is "any law, regulation, procedure, requirement or practice." This covers most conceivable acts of government. Chapter 11 applies to measures taken by all levels of government, from the federal to the municipal. The *Loewen* case in the US demonstrates that it even covers the judiciary.

3.3. The Process

Chapter 11's broad scope, and the expansive definition argued for some of its provisions, means that it goes far beyond commercial matters to areas of broader public interest, such as protection of health and the environment. The Methanex case, for example, seeks to test the appropriate balance between the public right to a clean and safe environment and the rights of an investor to enjoy the fruits of its investment. Both are important from a public policy perspective, and the institutions entrusted with performing the requisite balancing of goals should have the types of qualities we demand of the government bodies that make such decisions on a regular basis: legitimacy, accountability and transparency. The investor-state mechanism by which Chapter 11 cases are heard comes up short on all these counts.

The panelists themselves are not drawn from a permanent roster of arbitrators, and the selection process has the litigant choosing one of the three jurors, and collaborating on the choice of the third – a situation that invites biased choice. Pastor (2001:103) argues,

> "Dispute panels have worked well, but they are running into problems due to their *ad hoc* nature. Because panelists are not well paid, it has proven more and more difficult to locate expert panelists who do not have a conflict of interest. Moreover, the case law that has accumulated over the past decade requires an investment of time that few people without a conflict of interest would have. That is why the time has come to establish a permanent court and appoint judges for extended terms."

Further, the process allows only a very limited form of review – essentially a challenge of the arbitral award in the courts of the country where the Tribunal was legally located. The review then proceeds under the applicable international arbitration laws of the country or state/province in question, but the standard for review in such cases is much higher than that set for domestic appeals. The Tribunal would have to be shown to have committed an error of law so great that it amounted to an exceeding of its jurisdiction, rendering its decision null and unenforceable. In the end this is not an appeal process; the review cannot

rule on simple errors of fact or law, or substitute a decision for the one made by the tribunal.

The *ad hoc* nature of the panel selection, the lack of opportunity for appeal and the lack of *stare decisis*, or legal precedent, lead to what one commentator called a "crapshoot" every time a panel convenes.[9] There is no way to predict with any certainty how a panel will rule on a given question. The result is that it is worthwhile rolling the dice for firms who can mount moderately expensive high-stakes claims. The value of the WTO's permanent Appellate Body in giving consistency and predictability to the process can be seen here by contrast.

As a side-note: some observers criticize the investor-state process itself. Indeed, it is problematic that there is no "filter" to weed out frivolous or strategic claims. But the history of investment protection shows that it is best not left up to governments, who respond only to bigger players, and whose decisions whether to proceed with any given claim will always be tied up in the politics of the moment.[10]

To come back to the issue of panel selection: as noted above, the issues before many panels go beyond the purely commercial law matters in which the panelists will be expert. *Methanex*, for example, demands a knowledge of the economics of environmental regulation; would it have been feasible for the government of California to regulate leakage from underground storage tanks, rather than banning the leaking chemical that was the cause of concern? And it demands an understanding of environmental science and science-based policy-making; there is no clear scientific consensus on the human health effects of the banned chemical (as is almost always the case). Expert witnesses can only take non-expert arbitrators so far before legitimacy of process becomes an issue.

To some extent this problem can be addressed by allowing for full transparency of the proceedings, and for the input of "friends of the court" who are expert in the legal implications of the areas under study. The current practice is to restrict most arbitration documents, and to restrict access to the proceedings. The *Methanex* panel has broken new ground by declaring the broad public interest to the case, and in declaring itself both availed of the power to accept *amicus curiae* briefs, and minded to do so:

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[9] Participant, Ottawa ILSD session, March 18 2002.
[10] See Vandeveld (1992:23-25).

> "There is an undoubtedly public interest in this arbitration. The substantive issues extend far beyond those raised by the usual transnational arbitration between commercial parties."[11]

In fact, given the public interest in the cases, there seems no reason not to make all the case documents public, and to allow the same kind of access to proceedings allowed in any domestic court. While some contend that this would place confidential business information in the public domain, such documents could still be restricted, even as they are in the domestic setting. Or, as one commentator has suggested, transparency might be the price to be paid for the privilege of using the powerful and direct investor-state mechanism.[12]

As currently formulated the process lacks the kind of legitimacy, accountability and transparency that is required of institutions that must balance public policy objectives. Combined with Chapter 11's broad scope, and the loose definition of the provisions surveyed above, the weaknesses of process creates a situation of risk and uncertainty for regulators in non-commercial areas, and fuels the kind of public outrage that is not healthy for the integrity of the NAFTA. The reforms suggested here, now gaining in popularity even among the die-hard Chapter 11 supporters, might go some distance toward solving the problem.

Some transparency provisions were made in the FTC's Notes of Interpretation, discussed above. However, it is far from clear that this vehicle, which will work for interpretations of Chapter 11 provisions, will work for amending process failures. In fact, it has already been rejected as legally binding on an arbitral tribunal set up under Chapter 11 by the *Pope & Talbot* tribunal.[13]

Complainants are given the right under NAFTA to ask for hearings under the rules of either ICSID or UNCITRAL – both international treaties that are quite independent of the NAFTA to amend. Whereas the FTC has authority under NAFTA Article 1113 (b) to interpret Chapter 11 provisions, it has no power whatsoever to dictate the procedural rules under which the tribunals will operate. These rules are set at the beginning of each case in consultation with the Parties, and in accordance with the applicable body of law.

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[11] Methanex Tribunal (2001), para. 49.
[12] Konrad von Moltke, Mexico ILSD session.
[13] Decision and Order by the Arbitral Tribunal in NAFTA UNCITRAL Investor-State Claim, Pope & Talbot v. Canada, 11 March 2002, available at www.naftalaw.org.

For any significant change to occur in process, the NAFTA would have to be re-opened and amended to establish a tailor-made NAFTA court system, with rules established by the Parties themselves. Re-opening NAFTA is not something to take lightly, and it is unlikely any of the Parties have an appetite for it. But it is the only way, short of seeking to reform the ICSID and UNCITRAL, to fix the major process problems inherent in current system.

4. The Potential Contribution of the JPAC

Assuming that the JPAC agrees that there are problems with Chapter 11 that demand attention, or even that there is a need for further study, how might the Committee push for progress?

The Committee has an important role to play in this area, but the route for doing so is necessarily indirect. The key decision-makers on Chapter 11 are the trade Ministers, meeting as the Free Trade Commission. Only they have the power to amend or interpret the NAFTA. The JPAC does not have a mandate to advise the FTC, but it does have a mandate to provide advice to Council. The Council in turn, under Article 10(6) of the NAAEC, has a clear mandate to cooperate with the FTC to achieve the environmental goals and objectives of the NAFTA, *inter alia* by considering on an ongoing basis the environmental effects of the NAFTA.

Cognizant of this connection, in its Advice to Council 02-04 (March 8 2002), the Committee recommended opening up the Article 10(6) Environment and Trade Officials Group process. It also recommended adding Chapter 11 to the topics featured in the CEC's second Symposium on Environment and Trade, and raising the profile of the debate in the upcoming 2003 Environment and Trade Ministerial meeting. The Committee had tried on two previous occasions to prod the Article 10(6) Group into more visible action, with limited success.[14]

What more might be done? Several options for consideration are presented below.

1. The JPAC might be more direct in its advice, advising Council to actually give expert advice to the FTC on its own initiative, in accordance with its mandate under 10(6). Council already offered to do so in its June 1999 Final Communiqué, but the offer was never taken up. Since then the FTC has met and

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[14] See Advice to Council 99-08, and 98-08.

discussed the matter, with the resulting July 2001 notes of interpretation. But as far as the author knows, they have done so without the Council's cooperation or input.

The basis for the Council's advice would have to be a careful study, either commissioned by the Council or carried out by the Secretariat. It might also be informed by a CEC-convened meeting of experts on the subject. Ideally, the Council would advise the FTC on the current impacts of Chapter 11, and on the options for addressing them.

2. The JPAC might advise the Council to promote the adoption of improved language and process for investor protection in the ongoing FTAA negotiations. Such a recommendation already appeared in Advice to Council 01-02, but it was not a strong recommendation, and would bear repeating in the context of a dedicated communiqué on Chapter 11.

3. As it has done in Advice to Council 02-04, the JPAC might look for opportunities to raise the profile of the issue with the public, and to elicit public input, and encourage the CEC to fully exploit such opportunities. Building on the recommendation regarding the 2003 Environment and Trade Ministerial, the JPAC might advise the Council to push for using the event to announce a major deliverable in the search for a more environmentally sensitive Chapter 11 – perhaps the results of the recommended 10(6) process.

4. The JPAC might prepare a special advice to Council, summarizing the areas of concern that the Council should explore and outlining some of the options open for addressing those concerns. The basis for this advice might be any or all of: public input associated with the regular Council meetings; expert input elicited on an ad hoc basis, such as this paper; or a more in depth program of research undertaken by the JPAC on its own initiative.

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